October 31, 1991

COORDINATED ISSUE
GROUND TRANSPORTATION INDUSTRY
STRUCTURED SETTLEMENTS

Issue:

Deductibility of accrual for personal injury payments to be made under provisions of an agreement covering several years.

Facts:

Many railroads make several personal injury settlements during any given tax year. Although these vary in their individual format, a typical example may provide for an immediate lump sum payment, immediate assumption by the railroad of responsibility for medical bills of the injured employee, and monthly payments for a period of years or the remaining life of the injured party.

In some cases railroads have expensed on their books what was determined to be the present value of the individual settlement, while on their tax return a much larger figure is deducted representing the total amount anticipated to be paid over the life of the agreement in question.

Law and Argument:

Section 446 (a) of the Internal Revenue Code provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term "method of accounting" includes not only the over-all method of accounting of the taxpayer, but also includes the accounting treatment of any material item. No method of accounting however, is acceptable unless, in the opinion of the Commissioner, it clearly reflects income.

Treasury Regulation 1.162-10 states that amounts paid or accrued by a taxpayer on account of injuries received by employees, and lump sum amounts paid or accrued as compensation for injuries are proper deductions as ordinary and necessary expenses. Treasury Regulation 1.461-1(a)(2) covers rules for an accrual basis taxpayer. Notwithstanding, no accrual shall be made in any case in which all the events have not occurred which fix the liability. In Mooney Aircraft, Inc. vs. U.S., 420 F. 2d 400, (5th Circuit, 1969) it was held that even if the fact of liability and the exact amount are known, no deduction will be allowed if the date of payment is too far in the future. In the Mooney case that was 25 to 35 years.

The court upheld the disallowance of the deduction because of the discretion of the commissioner under Section 446(b) to reject any accounting method that does not clearly reflect income. The court felt that the payments would take place too far in the future and would thus unduly distort current income.

Position Taken by Taxpayers:

Taxpayers have used life expectancy tables to estimate how long beneficiaries would live, and multiplied out their payment amounts to arrive at the deduction claimed. Alternatively, proposal has been put forward that allowance of a fixed-certain sum should be made.

The fixed-certain sum originates from provisions of some contracts whereby payments will be made irrespective of death of the beneficiary for a specified number of years.

An accrual basis taxpayer can deduct expenses, when all events have occurred which establish the fact of liability and the amount can be determined with reasonable accuracy. It is erroneous to think that liabilities under structured settlement agreements may be deducted only on the cash basis, that is, as they are paid. Under structured settlements agreements liability to make payments in future years is established as of the end of each year in which an agreement is reached. The two requirements for accrual under the "all events" test, a definite liability that is fixed and determinable, are thus met. See Regulation 1.461(a)(2), and Revenue Ruling 69-429. The courts have likewise so held in Kaiser Steel Corporation v. United States, 82-2 USTC 9635, and Crescent Wharf and Warehouse Company v. Commissioner, 518 F. 2d 772 (9th Circuit 1975). Further, in recognition of the fact that there is no basis in law for holding otherwise, the Treasury has convinced Congress to enact legislation to change what it deems to be an abuse in structured settlement deductions. This change is now IRC 461(h) enacted as part of the Tax Reform Act of 1984, and it is effective only for returns filed after July 18, 1984.

Position Taken by the Service:

An expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability, and the amount thereof can be determined with reasonable accuracy. Since the beneficiaries will be paid until they die and since subsequent years payments are not yet due, the liability cannot be reasonably determined, nor is it payable. These are contingently affected by the beneficiary’s date of death.

A deduction in the current year for forecasted amounts to be paid years from now does not clearly reflect income, therefore is not allowable except to the extent of the current year's cash payments.

Note: Examiners should remain alert for the possibility of secondary issues. For instance, if a structured settlement includes compensation for back pay or lost time, it is both taxable wages to the recipient, and compensation subject to employment taxes imposed on the railroad. If the employee was injured while working on a capital project the settlement payments are to be capitalized as is any applicable employment taxes and legal fees paid by the railroad in obtaining the settlement.

The change in treatment of structured settlements is a change in accounting. In the alternative situation where a railroad uses a contingency reserve account for structured settlements, the beginning balance in such account, representing settlements of prior years deducted in full, can be recouped in the year of change under principles established in Revenue Ruling 81-93.